

WaterStreet QUARTERLY

CAPITAL MARKETS REVIEW AND OUTLOOK

3RD QUARTER 2007

Global Equities Continue Rise

Continued GDP and corporate earnings growth drive performance in an increasingly volatile and illiquid market.

GLOBAL EQUITY MARKETS continued to generate positive returns despite a dramatic loss of liquidity in August as banks tightened lending standards and reduced exposures on their balance sheets. Volatility increased to levels not seen since

the “technology bust” in 2000. Significant dispersions were seen throughout assets styles and capitalization. Despite these factors, the MSCI All Country World Index rose 2.2%, and the MSCI All Country World ex-US Index advanced

QUARTERLY OVERVIEW

■ US Equities

US stocks produced positive returns for the fifth consecutive quarter, despite a severe dislocation in the global credit markets spawned by US mortgage defaults. The exception was value stock indices which remain heavily weighted to financials. Mortgage lenders continued to exit the business and banks continued to write-down mortgage and real estate assets. Nevertheless, the S&P 500 Index returned 2.0% for the quarter led by energy and technology shares. All capitalization segments generated positive performance with the exception of small cap which lost 3.1%. Growth stocks significantly outperformed value in all segments. Of other note, extreme volatility returned in the quarter as the Dow Jones Industrial Average gained or lost more than 100 points 27 times. (page 3)

■ International (Non-US) Equities

Developed international issues lost 2.5% for the quarter, but experienced a 2.2% gain in US dollar terms as the dollar devalued 4.9% against the euro and 6.8% against the Japanese yen. Continued strong GDP growth

propelled emerging markets to new highs. The MSCI Emerging Markets Index returned 13.7% in US dollar terms and has returned 32.0% year-to-date. (page 3)

■ Fixed Income

International and US fixed income markets posted positive returns for the quarter with the Lehman Brothers Aggregate Index and the Citigroup Non-US World Government Index returning 2.9% and 8.1%, respectively. The continued dislocation in sub-prime mortgages and other asset-backed securities caused the continued flight to quality. Both the US Federal Reserve and the European Central Bank injected significant liquidity into the markets during August due to concerns about the solvency of many lenders and repricing of numerous CDO and SIV securities. (page 4)

■ Alternative Investments

Hedge funds and hedge fund of funds experienced a narrow range of returns during the quarter, despite extreme intraquarter volatility. The HFRI Hedge Fund of Fund Diversified Index returned 0.3% for the quarter. The Dow AIG Commodity Index

rallied 6.2% as grain prices and precious metal prices increased 23.2% and 13.6%, respectively. Real estate, as measured by the NAREIT Index, increased marginally as commercial properties maintained favorable cash flow while the mortgage market continued its free fall, declining another 28.2% in the quarter as measured by the NAREIT Mortgage REIT Index. Complex structured credit securities continued to be bid down dramatically. (page 5)

■ Global Outlook

World GDP growth remains robust in the 4.5%-5.0% range, which is significantly higher than the long-term trend of 3.7%. Inflation concerns continue to take a back seat to fears of a liquidity crisis and concerns over a potential US recession in 2008. Inflation remains around 2.0% in developed economies and 5.0% in emerging. The US Fed seems poised to reduce rates further while the Bank of Japan and the European Central Bank are likely to resume tightening in 2008. (page 7)

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2.8%, in US dollar terms. Corporate earnings continued to grow, albeit at a slower pace than in previous quarters. Leveraged buyout transactions came to an abrupt halt as financing disappeared. Bonds produced positive returns globally as many central banks cut short rates to avert a dramatic forced re-pricing of many credit derivative instruments.

Emerging market equity was again the best performing asset class for the quarter, returning 13.7% in the third quarter and 32.0% year-to-date. Returns were driven by persistent strong GDP growth and subsequent earnings expansion. China, India, and Brazil all returned over 20% for the quarter with China leading the way with a

41.1% return. The worst performing broad asset class was US small capitalization value, falling 6.3%, as measured by the Russell 2000 Value Index. Concerns over mortgage defaults and a slowdown in the US economy were the primary factors contributing to the decline as the index is heavily weighted to financials.

The most significant story of the quarter was the global re-pricing of risk brought about by continued turmoil in the sub-prime mortgage, Alt A mortgage, and structured credit markets. Banks and other lenders de-levered their balance sheets in response to these events causing further dislocations in the capital markets. The velocity in which liquidity disap-

peared in many securities markets was unprecedented. The first “bank run” in decades in the UK occurred as the Bank of England intervened to aid Northern Rock, a financial institution with high exposure to US sub-prime mortgage debt.

Lingering concerns in the credit markets include two million adjustable rate mortgages scheduled to reset in 2008, further downgrades of collateralized debt obligations (CDOs) by the major rating agencies, potential write-offs by major banks due to investments in bank conduit structures, and escalating problems in structured investment vehicles (SIVs). Many money market funds hold commercial paper backed partially by investments in CDOs and SIVs. Continued dislocations in these types of structured credit continue to have a contagion effect on all markets, including equities.

The European Central Bank (ECB), Bank of England, and Bank of Japan all put interest rate hikes on hold in the wake of the global credit crunch that occurred in August. The ECB injected large amounts of liquidity into domestic money markets as lending between European banks came to a halt. The ECB remains concerned about the lagging effects of the run-up in energy prices and the inflationary effects of rapid money expansion and may look to increase rates later in 2008. The US Federal Reserve cut the federal funds target by 0.50% to 4.75% and is poised for additional cuts to prevent further deterioration in the credit markets and to limit the possibility of a recession. The Fed remains concerned with higher than desired core inflation, wage inflation, and continued high energy prices.

The global economy continued to grow above its long-term trend of 3.7%. In 2007, world growth remains close to 5.0%, despite US growth slowing toward 2.0%. Major risk factors continue to be liquidity concerns in the credit markets, US current account deficits, and increases in core inflation. A new risk seems to be the possibility that the US could experience a recession in late 2008 or 2009.

EXHIBIT 1
MAJOR US STOCK MARKET INDICES

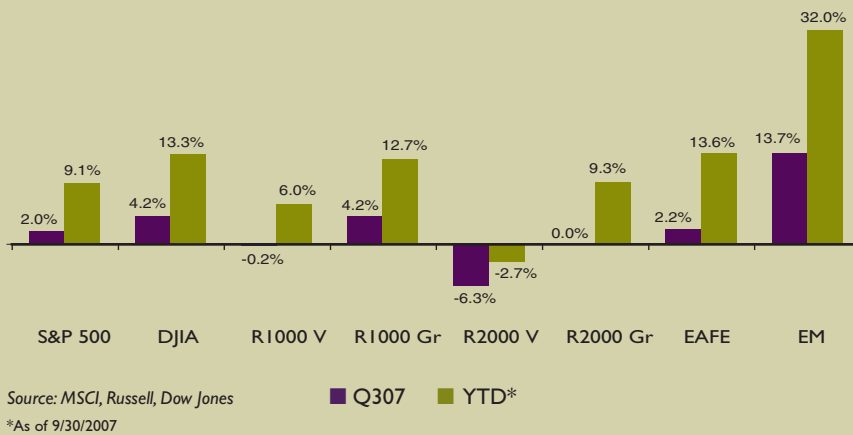
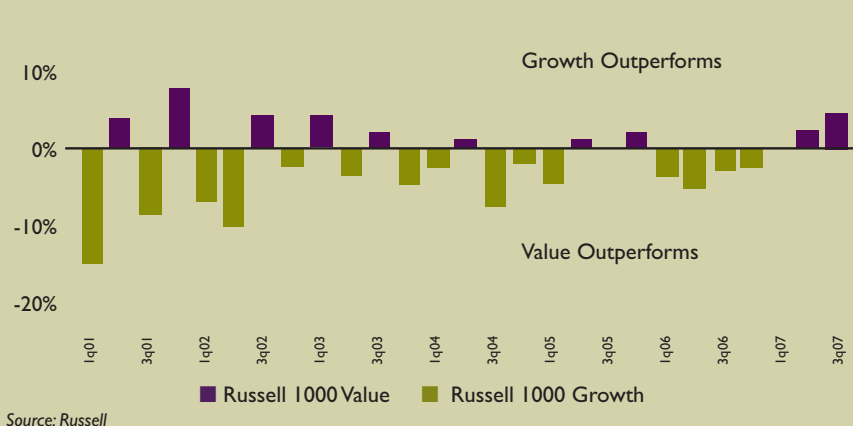


EXHIBIT 2
VALUE VS. GROWTH



US EQUITIES

The US stock market rose during the third quarter despite a tumultuous start with investors concerned about the sub-prime mortgage market. Markets recovered from the July sell-off as reports of continued economic growth and easing of inflationary pressures boosted investor confidence. The markets also gained momentum following the US Federal Reserve's rate cut. Volatility returned in September as investors' concerns about the short-term credit markets mounted again.

The S&P 500 Index ended the third quarter with a 2.0% gain, pulling the year-to-date return to 9.1%. The Dow Jones Industrial Average was up 4.2% while the NASDAQ returned 3.8% for the quarter. Refer to Exhibit 1 for returns on all major indices.

With credit less available, there was a significant decline in merger and acquisition (M&A) activity during the third quarter. Small capitalization stocks declined due to the slowdown in M&A activity and excessive valuations. The Russell 2000 Index lost 3.1% while its large capitalization counterpart, the Russell 1000 Index, posted a 2.0% gain for the quarter, marking the fourth time in the last six quarters that large capitalization stocks have outperformed small caps. This quarter yielded the worst performance for small capitalization stocks since the second quarter of 2006.

Growth stocks outperformed value in both the small and large capitalization issues. Much of the loss in the value style was driven by poor performance in the financial sector. The growth space favored investors as the strength of the US economy and the outlook for corporate earnings came into question. Refer to Exhibit 2 for value and growth returns.

For the second consecutive quarter, economic sector returns were led by the energy and information technology sectors. Oil prices reached a record high during the quarter and global demand continued to remain high, which con-

tributed to the energy sector's 9.8% return, bringing its year-to-date return to 28.7%. Only two of the S&P sectors posted negative returns for the quarter: financials and consumer discretionary. The financial sector lost 4.3% for the quarter as expectations of losses on sub-prime assets and a decrease in M&A activity caused investors to look for opportunities elsewhere. Consumer discretionary was the worst performing sector of the quarter with a 6.3% loss due to the slowdown in homebuilding and auto sales.

INTERNATIONAL EQUITIES

Developed Markets

International markets outperformed US equities as the US dollar weakened; however, most developed international markets underperformed the US equity markets in local currency terms. Most of the world was affected by the sub-prime mortgage led credit crisis as the cost of capital increased around the globe and investors fled riskier assets. The sell-off began in late July, bottomed in August, and then rebounded in September.

The MSCI EAFE Index, up a modest 2.2% for the quarter, was aided by strong returns from the Asia Pacific region, mainly in Australia and Hong Kong. European countries such as Germany, Finland, the Netherlands, and Spain also contributed to returns. Refer to Exhibit 3 for developed international country returns.

Hong Kong led the developed international markets due to a strong real estate market as well as the country's close economic ties to a booming mainland China. Hong Kong returned 23.9% during the quarter, bringing the year-to-date return to 31.8%. Japan lagged during the quarter, down 0.8%. Japanese financial stocks suffered due to the deteriorating credit markets and a significant slowdown in consumer spending. Several key economic indicators either stagnated or were negative, with GNP growth falling 0.3%.

Similar to the US, European investors reacted to the credit markets in the third

quarter by investing in high quality and less complex credit instruments. The European Central Bank injected billions of euros into the European money markets in August. The euro rose 5.4% to a record high against the US dollar. The Swedish krona appreciated 6.1%, and the Norwegian krone also appreciated considerably, rising 9.4%, as the Norges Bank raised rates twice during the quarter. The British pound did not experience as significant an increase, gaining only 1.9% against the US dollar because of domestic credit and liquidity concerns.

Growth outperformed value in the third quarter. The MSCI EAFE Growth Index returned 4.4%, while the MSCI EAFE Value Index returned 0.1%. Basic materials, specifically metal and mining stocks, in the UK and Australia were strong performers for the developed growth index. BHP Billiton, the world's largest diversified resources company, returned 33.8% due to high demand for commodities such as copper, coal, nickel, uranium, aluminum, oil, and gas. Finnish and Japanese information technology stocks, Nokia and Nintendo, also helped the growth index outperform the value index.

Emerging Markets

Emerging markets posted strong returns during the volatile third quarter, outperforming the developed markets by a considerable margin. The MSCI Emerging Markets Index returned 13.7% during the quarter, bringing the year-to-date return to 32.0%. Much like developed markets, emerging market currencies appreciated against the US dollar, causing a significant difference between local and US dollar returns.

Asian markets, driven primarily by China, was the top performing region during the quarter, rising 19%. Latin American markets were mixed; Chile and Mexico posted losses, while Brazil and Peru posted gains. Refer to Exhibit 4 for emerging markets country returns.

The BRIC (Brazil, Russia, India and China) markets led the gains as Brazil

returned 20.1%, Russia rose 9.0%, India gained 20.2%, and China rose 41.1%, in US dollar terms. Additionally, Peru and Turkey provided returns in excess of 20% for the quarter. These countries have shown no signs of slowing, and have experienced little to no impact from the global credit scarcity.

Demand for commodities boosted emerging market returns. Similar to developed international markets, the top performing sector during the quarter was basic materials, led by the metals and mining industry. The sector increased by 27.0% in the quarter due to rising demand for metals in China and other developing countries. Energy and indus-

trial sectors also experienced healthy returns gaining 18.6% and 21.6%, respectively. Commodity rich emerging market countries are likely to remain relatively well supported given continued above trend global growth.

Emerging market economies are becoming more resilient, resulting in sovereign debt upgrades and strong currencies. These developing countries are experiencing current account surpluses (above 3% of GDP in 2006), reduced foreign debt, strong currencies, and increased political stability. Demand for roads, bridges, rail, electrical supply, and housing projects is at record levels across emerging market countries, and is

expected to continue for the foreseeable future. The spending boom in these economies is fueled by easy access to capital coupled with low inflation and interest rates.

FIXED INCOME

As previously mentioned, the US Federal Reserve cut the Fed funds rate by 0.50% late in the third quarter. Prior to the rate cut, yield curves had already steepened in the US, UK, and Europe in anticipation of central banks refraining from increases. As the sub-prime market continued to make headlines, investors grew more risk averse and sought the safety of traditional bonds. This caused yields on government bonds to fall during the quarter. Most bond indices posted positive returns for the quarter. The Lehman Brothers Aggregate Bond Index was up 2.9% for the quarter and 3.8% year-to-date. Refer to Exhibit 5 for bond market index returns. Returns for mortgage and asset-backed securities lagged behind treasuries on a like-duration basis. Mortgage yield spreads widened in the environment of heightened volatility as continued sub-prime market problems put pressure on prices.

High yield bonds, as well as other lower quality investments, had the most difficulty during the quarter as several issues were down graded by the rating agencies. The Merrill Lynch High Yield Master Index posted a 0.4% return for the third quarter. High yield bonds performed at their lowest level in over five years; however, investors found opportunities and favorable prices in late August and September. During the third quarter, performance seemed to be driven by higher quality bonds within the speculative grade class. The top performing areas were defensive sectors such as utilities, energy, and non-cyclicals, while banking, brokerage, and real estate sectors posted poor returns.

Emerging markets fixed income had a strong third quarter in spite of the volatile global markets in July and August. Locally

EXHIBIT 3
DEVELOPED MARKETS
(In US Dollars)

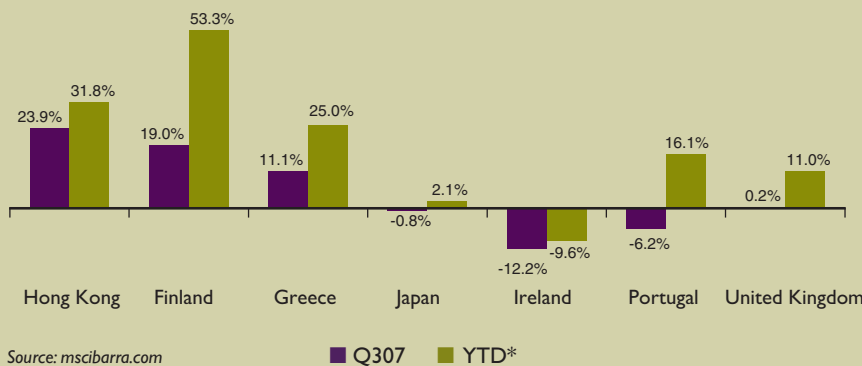
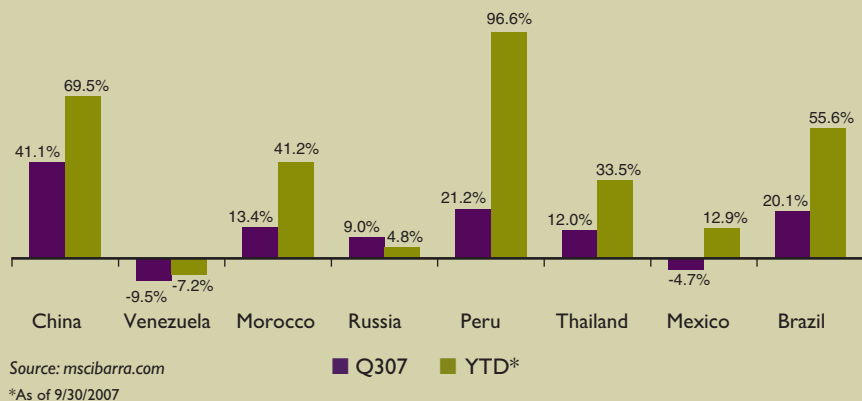


EXHIBIT 4
EMERGING MARKETS
(In US Dollars)



issued emerging market bonds outpaced their dollar denominated counterparts. Unlike most periods of global volatility, emerging markets seemed to be very resilient compared to other areas of global credit this quarter. The JP Morgan Emerging Markets Bond Index posted a 2.6% return for the quarter, bringing the year-to-date return to 3.5%. Performance in the first half of the quarter suffered as investors' risk aversion increased. Emerging market debt turned around in September due to the injection of liquidity into the system by central banks, allowing the quarter to end on a positive note. The top performing emerging debt market for the quarter was Brazil. Brazil continues to run large trade surpluses despite its increasing imports. The country is also on track to meet its 3.75% GDP fiscal surplus for the year. Other high performers included Mexico and Ecuador. Mexican markets received momentum from a congressional approval of the fiscal reform package. This is expected to lead to increased tax revenues of 1%-2% of GDP per year.

ALTERNATIVE INVESTMENTS

The third quarter saw an upheaval in financial markets, primarily in the credit markets. Like most financial dislocations that have occurred throughout history, what starts in one market in the financial world, soon spills over into adjacent, possibly unrelated sectors, to produce contagion and ultimately high correlations across seemingly unrelated markets.

In the third quarter, three out of nine hedge fund strategies (as represented by their respective Hedge Fund Research Index) generated losses between 0.2% and 1.4%, with Distressed Securities bearing the brunt of the negative returns. However, the hedge fund industry as a whole gained 1.3% during the quarter as measured by the HFRI Fund Weighted Composite Index, bringing the year-to-date gain to 8.8%. Hedge funds of funds gained a modest 0.2% for the quarter, advancing 8.1% on a year-to-date basis.

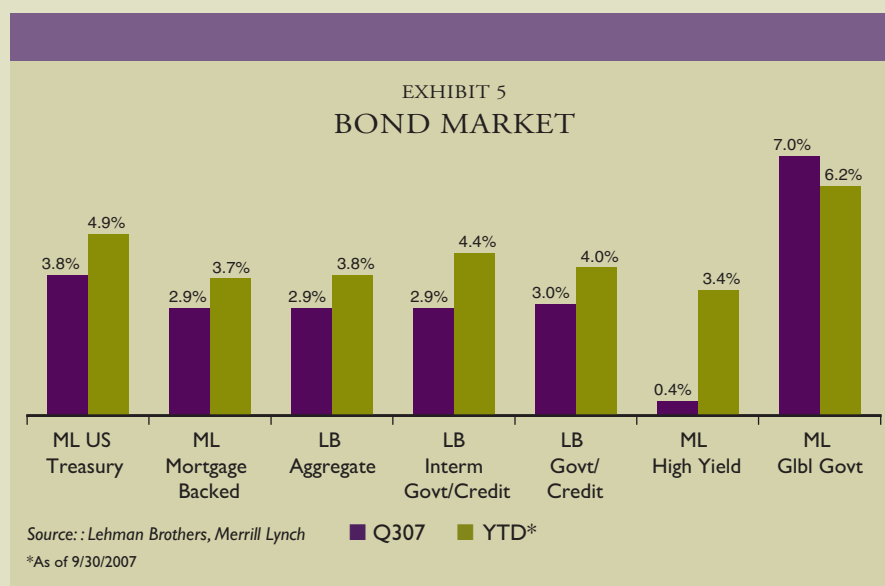


Exhibit 6 provides returns for the hedge fund industry by strategy.

Fears of a sub-prime meltdown were realized during the quarter and write-offs of bad mortgages by banks in the US and international markets picked up steam. Write-offs by Wall Street firms, global banks, and SIVs are approaching \$100 billion. Some have started questioning whether sub-prime losses and write-offs will reach the magnitude seen as a result of the S&L crisis in the late 1980s where losses totaled an estimated \$400 billion. Considering the declining housing market and the amount of mortgages that will reset at higher interest rates in 2008 and 2009, defaults on home loans will certainly rise. This suggests continued volatility in credit and equity prices in the foreseeable future.

In July, sub-prime fears were digested leading to modest losses across most non-equity oriented strategies. In August, the write-downs began and pricing of credit securities were called into question. Sub-prime fears shook all markets with the short-term commercial paper market screeching to a halt and bid/ask spreads on credit instruments reaching 40-50 points. This dislocation in credit spilled over to hedge fund equity strategies as many managers had to de-lever their portfolios to meet investor redemptions or margin calls. Deleveraging caused a drop in prices of

widely held quality securities, which were sold to generate liquidity. This issue, coupled with the accretion in price of many lower quality stocks as a result of short-covering, led many quantitative long/short equity managers to experience losses in August that were never seen before. As a result, the HFRI Equity Market Neutral Index lost 0.6% over the quarter. Another major cause for concern was the high correlation among market neutral managers as commonality of security risk was revealed.

Exhibit 7 presents equity volatility as measured by the VIX Index. Volatility remains elevated with wide fluctuations in equity prices on a day-to-day basis. This has aided many fundamental long/short strategies as can be seen with the HFRI Equity Hedge Index posting a relatively strong 1.6% return for the quarter. Volatility should continue to provide return opportunities for fundamentally sound long/short managers.

Credit strategies came under pressure during the quarter across all markets, including hedge funds. Distressed investments, as represented by the HFRI Distressed Securities Index, experienced a loss of 1.4% during the quarter. The strategy was down more than 2.0% in July and August, but gained some momentum in September. High quality debt to junk debt yield spreads widened significantly during

the June to August corridor. Average spreads during this time period widened from 2.6% to 4.7%. Assuming a 5-year duration on a junk bond portfolio, a widening of this magnitude would equate to a 10.4% loss in value. Spreads contracted during September to close at 4.2% (still below the historical average of 4.9%). The widening was caused by the down-grading of multiple CDOs in the market. Investors witnessed phenomenal overnight drops in ratings from AAA to B. Significant downgrades have continued into the fourth quarter, and will persist as the sub-prime debt issue works its way through the market. Many hedge fund and private equity firms are mobilizing capital to take advantage of the fall-out as investors overreact by throwing the good debt out with the bad. Top-tier hedge fund managers should continue to navigate the credit storm successfully.

Commodities

The Dow AIG Commodity Index rose sharply in September to end the third quarter up 6.2%. Energy, the largest sector of the index, increased 2.1% during the quarter as strong gains in crude oil were offset by losses in natural gas. Gains in grains and precious metals boosted the return of the total index. Refer to Exhibit 8 for Dow AIG Commodity Index returns.

Crude rose 10.2% in July and the futures curve shifted into backwardation for the first time since October 2005. Backwardation is a market situation in which futures prices are progressively lower in the back-end months and higher in the near-term months. It generally indicates a lower value placed on inventory and a strong prompt market. The shift was due to heavy buying on the short end of the curve as supply surpluses eroded, as well as apparent hedging (short) on the back end of the curve by producers. In August, crude prices dipped below \$70 before rebounding on signals of increased oil demand. Also boosting prices, the Department of Energy announced gasoline inventories at their lowest recorded level. Crude prices continued to rise in September due to low inventories, disruptions in the Gulf of Mexico from tropical storms, and the sliding US dollar. Prices peaked at \$83.90 after the Fed rate cut, then ended September at \$81.66, up 15.8% for the third quarter.

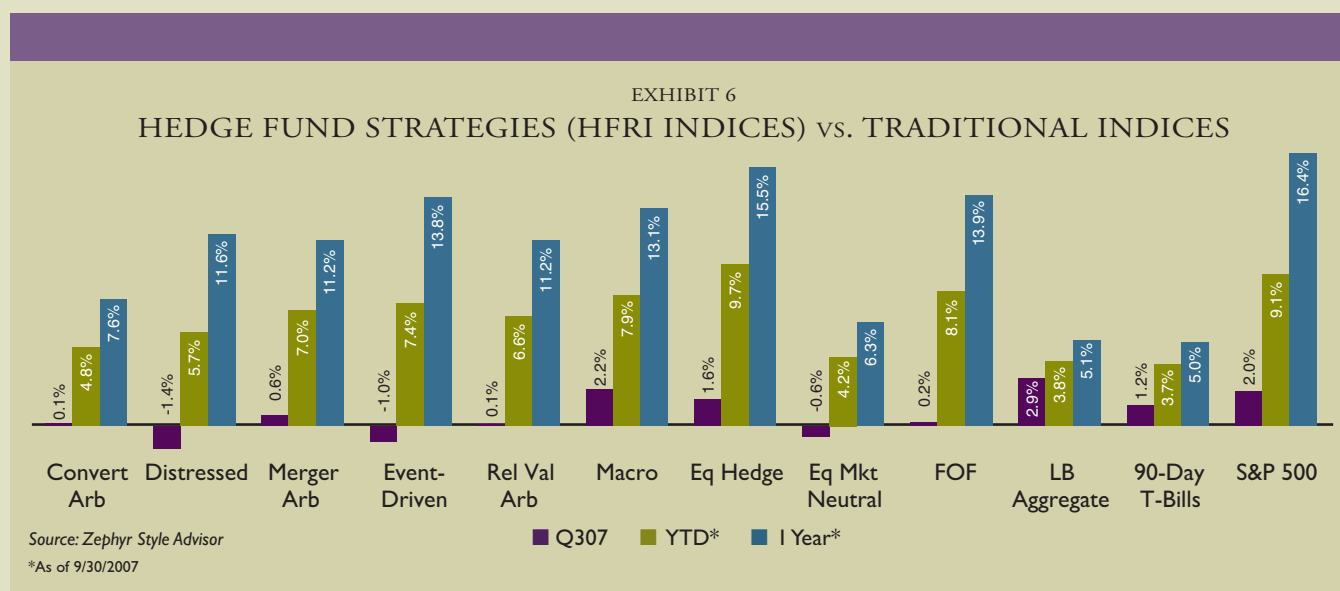
Abundant storage, mild weather, and overall weak demand led to a 14.3% decline in natural gas during the third quarter. Storage levels persisted well above five-year averages. Despite a price boost in September due to the potential impact of gulf storms, natural gas has declined 16.6% in 2007.

Grains saw the largest increase of the quarter, up 23.2%. Wheat hit a series of multi-year highs caused primarily by supply concerns. Lack of rain has damaged winter crops in Australia and Argentina. Additionally, the weakened dollar has led to increased demand for US exports of grains.

Other sectors of the index saw mixed results during the quarter. Industrial metals suffered selling pressure due to concerns over slowing global growth, ending the quarter down 3.3%. Alternatively, precious metals benefited from the weakened US Dollar, rising 13.6% for the quarter. Livestock declined 1.3% for the quarter after a very volatile hog market. Hog prices shot up 14.5% in July on rumors of an increase in Chinese imports of US pork. The Chinese pork industry has been damaged by an outbreak of Blue Ear Disease. However, considerable trade and tariff barriers prohibit significant imports to supplement supply. In August, hopes of Chinese imports were dashed and US supply surged, causing hog prices to fall dramatically in August and September.

Real Estate Investment Trusts (REITs)

The US REIT market, as represented by the NAREIT All REIT Index, overcame July losses to end the quarter up 0.3%. As with the rest of the equity market, REITs



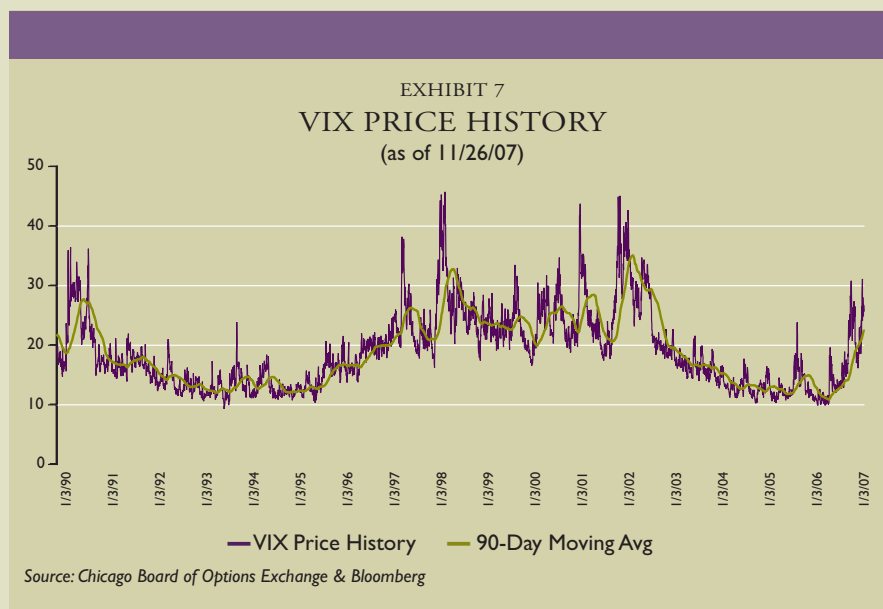
were highly volatile in the third quarter. Prices fell sharply in the first half of the period as credit concerns intensified and the sector was plagued by financing concerns and the implication for real estate values. During the second half of the quarter, the sector rose with the rest of the equity markets in the wake of the Fed's rate cuts. Health care REITs performed well during the quarter as investors favored their relatively stable earnings and long-term leases. Shopping centers and regional malls also benefited from the longer-term nature of their leases and relatively stable earnings. The industrial sector performed well as it has the most exposure to globally oriented REITs, which benefit from international trade. Mortgage companies continued to suffer during the third quarter with the NAREIT Mortgage REIT Index declining 28.2% in the third quarter resulting in a 42.5% loss in 2007.

European markets suffered for the second consecutive quarter, with the MSCI Europe Real Estate Index declining 9.1%. Expectations for both lower property returns and dividend yields have caused UK REIT share prices to decline. The market's negative view of UK real estate companies has made them among the cheapest in the world, which allows opportunistic purchases if a positive catalyst were to spark renewed investor interest in UK real estate. Austria's real estate market also struggled as it was struck with corporate governance issues regarding share buybacks.

Emerging market real estate saw the largest gains of the quarter. MSCI Emerging Markets Real Estate Index rose 25.3% during the third quarter. Hong Kong was a standout, benefiting from its perceived insulation from the impact of US credit market turmoil and its position as a gateway to China.

GLOBAL OUTLOOK

Global growth remains robust in the 4.5%-5.0% range for 2007. Forecasted growth rates are significantly above the long-term trend line of 3.7%. GDP growth in the US and France should hover



around 2.0% with other G-7 countries also experiencing a slowdown. Japan looks particularly vulnerable as consumer spending has slowed once again. Growth in China, India, Asia ex-Japan, Central and Eastern Europe, and Latin America all continue to grow in a range of 6%-11%.

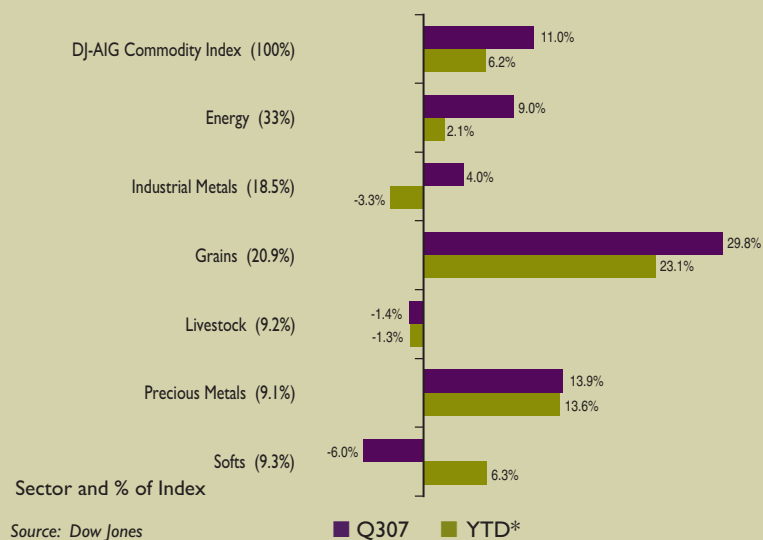
The US economy is forecasted to slow to 2% in the fourth quarter. The residential housing sector continues to be a significant drag on the economy with housing starts hitting 10-year lows. Housing related manufacturing, lagging effects of increased energy costs, and the normalization of short-term interest rates were additional detractors. It seems unlikely the US economy can realize any significant growth until the housing sector bottoms and consumer spending picks up again, possibly later in 2008. The cost of financing huge current account and fiscal deficits also continues to create significant headwinds. As previously mentioned, the US dollar depreciated 4.9% versus the euro and 6.8% versus the yen during the third quarter. On a positive note, the current account deficit has finally started to fall, declining to 5.6% of GDP from a high of 7.2%. We believe the US dollar could continue to drift lower as China ever so slowly de-pegs its currency and the threat of a US recession increases. Additionally, many Arab gulf states are thinking of abandoning their currency pegs

to the US dollar to limit inflation. However, a full scale rout of the US dollar seems unlikely given the huge amount of currency reserves held in US dollars by China, Japan, the UK, and Saudi Arabia. We believe that the major downturn in the US dollar has already occurred. However, the dollar's share of global currency reserves seems very likely to decrease from current levels. Positive US economic factors include a strong labor market, real wage growth, and continued consumer spending.

In Europe, GDP growth has begun to slow, rising just 0.3% quarter over quarter. Although GDP growth is expected to reaccelerate to 2.3% later in 2008, rising interest rates and a stronger euro will limit the upside. Growth continues to be fueled by strong exports and continued capital investment. Additionally, increased commerce and investment in Central and Eastern European countries will continue to aid organic growth. The European Central Bank increased rates in September by 0.25% to 4.25%, but have been forced to suspend any further tightening because of continued dislocation in the global credit markets.

In the UK, GDP growth rose to 2.8%, in line with its longer-term trends. Further tightening by the Bank of England appears unlikely as inflation fell back to 1.8% in August. Continued GDP growth seems likely as business investment and

EXHIBIT 8
DOW AIG COMMODITY INDEX



the labor market remain healthy.

In Japan, the recovery that began in 2003 continues, but has lost some momentum as GDP contracted by 0.3% quarter over quarter. Investment and consumer spending remained flat while trade slowed. The Japanese economy should reaccelerate in 2008.

US equity valuation characteristics improved slightly during the quarter as rising corporate earnings and a decline in longer-term bond yields increased the attractiveness of equities. The earnings yield on the S&P 500 Index was 5.6% at quarter end while the yield on the 10-year US Treasury note stood at 4.6%. Price-to-Earnings ratios (P/E) for most equity asset classes are in line with historical averages. The forward P/E for the S&P 500, Russell Midcap, and Russell 2000 stood at 15.3, 17.6, and 20.6, respectively. Smaller capitalization stocks, represented by the Russell 2000, remain overvalued by 10%-15%. International equities remain cheaper than US equities by approximately 10% as aggregate global earnings growth continues to eclipse that of the US. The forward P/E for international large capitalization stocks, as measured by the MSCI EAFE, stood at 13.5 at quarter

end. MSCI Emerging Markets P/E was 14.1 at quarter end, approximately 13% below its historical average of 16.3. The MSCI EAFE Small Cap ended the quarter with a forward P/E of 15.4.

All traditional fixed income indices, with the exception of high yield, rallied in the third quarter. Continued dislocation in sub-prime mortgages prompted a full scale rout of many asset-backed and structured credit securities. Many of these "packaged" securities experienced 20%-50% drops after being forced to mark the underlying securities to the market, many due to ranking agency downgrades. This contagion spilled over to the equity market, creating historically high volatility correlations resulting in significant losses for many quantitative hedge fund managers.

Although we have discussed the risks to the global capital markets of a major credit dislocation for 18 months (and it did finally happen in August), we did not expect equities to react the way they did, which was to bounce back and end the quarter in positive territory. However, the credit crisis is not over and may continue for a few more quarters.

The latest casualties in the credit malaise are Structured Investment Vehicles

(SIVs) which are now sharing the headlines with Collateralized Debt Obligations (CDOs) and sub-prime mortgages. The first SIVs were founded in the mid-1980s as bankruptcy-remote entities and were sponsored primarily by large banks for the purpose of generating leveraged returns by exploiting the differences in yields between short-term borrowing rates and longer-term returns from structured product investments. The balance sheets of SIVs typically contain assets such as asset-backed securities (ABS) and other high-grade securities. SIVs are funded through issued liabilities in the form of commercial paper (CP), medium-term notes (MTNs), and subordinate capital notes. SIVs attempt to hedge out interest rate and currency risks using swaps and other derivative transactions. Unlike a CDO, an SIV has a perpetual structure as it buys new assets as old ones mature. As such, they can be viewed as a virtual bank continually issuing CP at close to the interest rate of LIBOR and then purchasing longer-term asset-backed, mortgage-backed, and CDO securities.

A typical SIV might make 0.25%-0.35% more on the bonds than it has to pay to the commercial paper. This spread represents the SIVs profits, which are paid to the capital note holders and the investment manager. The capital note holders are the "first loss investors" in that if any of the bonds purchased default, the capital note investor will lose his investment before the CP investors. Most SIVs are typically levered 10-20 times and carry both solvency and liquidity risk. If the underlying bonds (such as sub-prime mortgages) default and stop paying interest, then the SIV will not be able to finance the CP liabilities and, will in turn, create losses to capital as the collateral is re-priced. Liquidity risk is also present, as was witnessed in August when CP spreads widened 100 basis points and new issuance of paper virtually halted because of suspect collateral, making it difficult for SIVs to refinance their obligations. The result was that many SIVs were forced into selling their Asset Based Securities (ABS)

and mortgage backed securities (MBS) investments into a very depressed and illiquid market, creating capital losses for note holders. This was exactly what happened to an SIV sponsored by Texas Pacific Group which became insolvent in August and subsequently closed down with investors swallowing over \$2 billion in losses. As the downward re-pricing of derivative structures continues, large financial institution SIV sponsors will face two choices: let their investors take the capital losses or move the structures onto their balance sheets and take write-offs against earnings.

No one really knows how much SIV, CDO, and sub-prime debt will be written off in the coming months, but some estimates are as high as \$400 billion. The uncertainty surrounding these types of investments will not end soon, in part because the rating agencies are limited by their own staff as to the number of these structures they can review each quarter. Consequently, we believe it may take up to six quarters for agencies to work off the backlog of required reviews and subsequent downgrades.

We believe the continued dislocations in the credit markets and the cost of financing the huge US current account and fiscal deficits will continue to create significant headwinds for the US and the global economy. Additionally, the continued devaluation of the US dollar forces oil-producing countries to increase prices to compensate for their lost buying power as oil is traded globally in US dollars. The result is the exportation of inflation globally. The largest risk factor now seems to be the possibility of a US recession in late 2008. Alan Greenspan, former Chairman of the US Federal Reserve, commented in October that the chances of a US recession in 2008 are between 30%-50%.

Course of Action

We continue to favor stocks over bonds and international equities over US equities. Earnings growth remains in the mid to high single digits in the US and continental Europe. Earnings growth in emerg-

ing market countries remains over 10%. We believe bond yields provide standard returns for most investors. Traditional bonds did enjoy a rally in the third quarter, primarily due to a flight to quality and the US Fed's discount rate cuts. We believe the Fed will not lower the Fed funds rate below 4.0%, unless the US economy starts slipping into a recession. Headline inflation continues to run over 3.0% and could continue to rise as the lagging effects of higher energy prices work their way through the economy. Prospects for rate cuts remain low for the European Central Bank and the US Federal Reserve as wage growth and overall Core CPI remain above targets.

US Equity valuations remain in line with longer-term historical averages. International valuations remain attractive versus US, and international returns could be enhanced for US investors if the dollar continues to weaken. We believe a further slight devaluation in the US dollar is likely over the short run. We continue to recommend an overweight position to non-US equities with approximately 65% committed to international large, small, and emerging markets.

Equity style and capitalization opinions remain unchanged from last quarter. We still recommend overweighting growth versus value. Year-to-date growth stocks have outperformed value stocks by 6.7% in large capitalization, 8.5% in mid capitalization, and 12.0% in small capitalization. We believe the fall in financial stocks due to the turmoil in the credit markets will continue for another two to four quarters. Financial stocks are the largest percentage of the value indices. Additionally, value stocks tend to be more sensitive to economic cycles and are therefore more negatively affected by slowdowns in the economy. We have been talking about a possible resurgence in technology stocks for some time. That is certainly happening now as many technology firms have posted impressive earnings reports the past two quarters. We continue to be ambivalent as to market capitalization. Although large capitaliza-

tion issues represent better value with regard to price-to-earnings, book, and cash flow potential, these factors do not necessarily indicate that large cap issues will be the best performers. This was evidenced last quarter when the S&P 500 Index returned 4.2% while the much more expensive Russell 2000 Growth Index returned 9.3%.

In the alternative asset classes, we continue to expect that above trend global GDP growth will continue to exert pressure on commodity prices. As such, we anticipate returns in these asset classes to be higher than our long-term expected return of 10%. Private equity, in the form of leveraged buyouts, has virtually disappeared as the major banks that were providing the bridge financing left the market. Growth capital private equity in Latin America, and East and Central Europe remains quite attractive. Global real estate, especially the residential sector, continues to fall. The global real estate bubble continues to burst as commercial real estate investment trusts and operating companies have joined the rout. We remain underweight to this asset class for the time being, but believe the asset class will bottom in 2008 as the market absorbs over \$600 billion in mortgage resets in the US.


We remain optimistic with regard to most hedge fund strategies. Increased volatility in most areas of the capital markets seems to be here to stay as the shake-out in credit continues. Given this backdrop, we expect long/short managers to do well. Event driven managers will continue to find opportunities, as consolidation continues in many global economic sectors. Quantitative and market neutral strategies will begin to recover from last quarter's historic drawdowns. However, we expect somewhat lower returns from these strategies going forward as most managers have significantly reduced leverage and security specific risk. Low volatility hedge fund of funds should continue to be a good bond alternative. We prefer to invest in hedge fund of funds as we view them as safer than single manager strategies. 

EXHIBIT 9: Output, Prices and Jobs

% change from one year ago

	Gross Domestic Product				Industrial	Consumer Prices			Unemployment
	latest	qtr*	2007	2008	latest	latest	year ago	2007	Rate‡, %
United States	+1.9 Q2	+4.0	+2.0	+2.2	+1.7 Aug	+2.0 Aug	+3.8	+2.8	4.6 Aug
Japan	+1.6 Q2	-1.2	+2.0	+1.9	+4.3 Aug	-0.2 Aug	+0.9	nil	3.8 Aug
China	+11.9 Q2	na	+10.5	+9.6	+17.5 Aug	+6.5 Aug	+1.3	+3.0	9.5 2006
Britain	+3.1 Q2	+3.3	+2.9	+2.1	+0.9 Jul	+1.8 Aug§	+2.5	+2.3	5.4 Jul††
Canada	+2.5 Q2	+3.6	+2.5	+2.5	-0.5 Jul	+1.7 Aug	+2.1	+2.2	6.0 Aug
Euro Area	+2.5 Q2	+1.4	+2.6	+2.1	+3.7 Jul	+2.1 Sep	+1.7	+2.0	6.9 Aug
Austria	+3.7 Q2	+4.0	+3.2	+2.6	+5.3 Jul	+1.7 Aug	+1.8	+1.8	4.2 Sep
Belgium	+2.9 Q2	+2.5	+2.6	+2.1	+3.3 Jul	+1.5 Sep	+1.2	+1.7	11.9 Aug ††
France	+1.3 Q2	+1.3	+1.8	+2.0	+2.6 Jul	+1.2 Aug	+1.9	+1.4	8.0 Jul
Germany	+2.5 Q2	+1.0	+2.7	+2.2	+4.4 Jul	+2.5 Sep	+1.0	+2.0	8.8 Sep
Greece	+4.1 Q2	na	+3.8	+3.2	+3.5 Jul	+2.5 Aug	+3.5	+2.6	8.2 Jun
Italy	+1.8 Q2	+0.5	+1.8	+1.5	-0.2 Jul	+1.7 Sep	+2.1	+1.9	6.0 Q2
Netherlands	+2.6 Q2	+1.2	+2.5	+2.2	+4.1 Jul	+1.3 Sep	+1.3	+1.6	4.5 Aug††
Spain	+4.0 Q2	+3.8	+3.7	+2.7	+4.0 Jul	+2.2 Aug	+3.7	+2.7	8.0 Aug
Czech Republic	+6.0 Q2	+5.7	+5.7	+4.2	+11.5 Jul	+2.4 Aug	+3.1	+2.6	6.4 Aug
Denmark	+0.6 Q2	-1.6	+1.7	+1.8	nil Jul	+1.1 Aug	+2.0	+1.7	3.3 Aug
Hungary	+1.2 Q2	+0.2	+2.4	+3.0	+9.4 Jul	+8.3 Aug	+3.5	+7.5	7.2 Aug ††
Norway	+3.9 Q2	+3.5	+3.1	+2.6	+2.9 Jul	+0.4 Aug	+1.9	+0.8	2.5 Jul††
Poland	+6.7 Q2	na	+6.5	+5.1	+9.0 Aug	+1.5 Aug	+1.6	+2.3	12.0 Aug††
Russia	+7.8 Q2	na	+6.7	+6.2	+3.8 Aug	+8.7 Aug	+9.7	+7.8	5.7 Aug††
Sweden	+3.5 Q2	+3.7	+3.4	+3.0	+5.2 Jul	+1.8 Aug	+1.6	+1.8	4.8 Aug††
Switzerland	+2.8 Q2	+3.0	+2.6	+2.1	+9.8 Q2	+0.7 Sep	+0.8	+0.7	2.6 Aug††
Turkey	+3.9 Q2	na	+5.6	+5.3	+3.9 Jul	+7.1 Sep	+10.6	+8.7	8.9 Q2††
Australia	+4.3 Q2	+3.8	+4.1	+3.5	+5.5 Q1	+2.1 Q2	+4.0	+2.4	4.3 Aug
Hong Kong	+6.9 Q2	+8.2	+6.2	+5.2	-2.3 Q2	+1.6 Aug	+2.5	+1.9	4.2 Aug††
India	+9.3 Q2	na	+8.4	+7.9	+7.1 Jul	+6.5 Jul	+6.7	+5.7	7.6 2006
Indonesia	+6.3 Q2	na	+6.3	+6.4	+3.9 Jul	+7.0 Sep	+14.5	+6.1	9.8 Feb
Malaysia	+5.7 Q2	na	+6.0	+5.8	+2.1 Jul	+1.9 Aug	+3.3	+2.1	3.4 Q2
Pakistan	+6.6 2006**	na	+6.4	+5.9	+6.0 Jun	+6.5 Aug	+8.9	+6.7	6.2 2006††
Singapore	+8.6 Q2	+14.0	+7.0	+5.1	+13.8 Aug	+2.9 Aug	+0.7	+1.2	2.4 Q2
South Korea	+5.0 Q2	+7.4	+4.9	+5.2	+11.2 Aug	+2.3 Sep	+2.5	+2.3	3.2 Aug
Taiwan	+5.1 Q2	na	+4.3	+4.6	+10.2 Aug	+1.6 Aug	-0.6	+1.0	3.9 Aug
Thailand	+4.4 Q2	+5.2	+4.6	+5.0	+7.2 Jul	+2.1 Sep	+2.7	+2.0	1.6 Jun
Argentina	+8.7 Q2	+8.8	+7.7	+5.7	+0.1 Aug	+8.7 Aug	+10.7	+8.6	8.5 Q2††
Brazil	+5.4 Q2	+3.2	+4.7	+4.5	+6.8 Jul	+4.2 Aug	+3.8	+3.7	9.5 Aug††
Chile	+6.1 Q2	+6.5	+6.1	+5.1	+4.0 Aug	+5.8 Sep	+2.8	+3.7	7.6 Aug††††
Colombia	+6.9 Q2	+4.4	+6.6	+5.8	+12.4 Jul	+5.0 Sep	+4.6	+5.6	11.1 Jun††
Mexico	+2.8 Q2	+5.3	+2.9	+3.2	+2.4 Jul	+4.0 Aug	+3.5	+4.0	3.9 Aug††
Venezuela	+8.9 Q2	na	+6.7	+4.0	+11.2 Jun	+15.3 Sep	+15.3	+18.1	8.4 Q2††
Egypt	+7.4 Q1	na	+7.0	+7.3	+10.5 2006	+8.5 Aug	+8.9	+8.4	9.0 Q1††
Israel	+4.4 Q2	+6.1	+5.0	+4.5	+3.1 Jul	+1.0 Aug	+2.2	+0.5	7.6 Q2
Saudi Arabia	+4.3 2006†	na	+4.8	+5.6	na	+4.4 Aug	+1.6	+3.4	na
South Africa	+5.0 Q2	+4.5	+4.8	+5.1	+3.1 Jul	+6.7 Aug	+5.4	+6.0	25.5 Mar††

* % change on previous quarter at an annual rate.

† The Economist poll.

‡ National definitions.

§ Not seasonally adjusted.

** Economist Intelligence Unit estimate/forecast.

†† Aug-Oct.

†† Sep-Nov.

§§ Year ending June.

EXHIBIT 10: Trade, Exchange Rates, Budget Balances and Interest Rates

	Trade Balance		Current account balance		Currency units, per \$		Budget	Interest Rates, %	
	latest 12 months, \$bn	latest 12 months, \$bn	% of GDP 2007†	Apr 3rd	year ago	% of GDP 2007‡	3-month latest	10-year gov't bonds, latest	
United States	-818.7 Jul	-793.2 Q2	-5.6	-	-	-1.6	4.81	4.54	
Japan	+93.2 Jul	+192.6 Jul	+4.6	117	118	-2.5	0.73	1.69	
China	+244.9 Aug	+249.9 2006	+10.7	7.51	7.90	-0.7	3.85	4.65	
Britain	-158.6 Jul	-86.6 Q2	-3.2	0.49	0.53	-2.7	6.20	4.99	
Canada	+47.9 Jul	+21.9 Q2	+1.8	1.00	1.13	0.6	3.97	4.34	
Euro Area	+29.2 Jul	+11.2 Jul	+0.2	0.71	0.79	-0.7	4.80	4.33	
Austria	+1.3 Jul	+13.2 Q1	+2.9	0.71	0.79	-0.5	4.79	4.42	
Belgium	+17.6 Jul	+14.4 Jun	+2.2	0.71	0.79	-0.1	4.86	4.46	
France	-40.1 Jul	+15.8 Jul	-1.2	0.71	0.79	-2.4	4.79	4.44	
Germany	+288.1 Jul	+192.3 Jul	+5.4	0.71	0.79	0.4	4.79	4.33	
Greece	-47.8 Jun	-36.7 Jul	-10.5	0.71	0.79	-2.4	4.79	4.61	
Italy	-16.3 Jul	-49.4 Jul	-2.4	0.71	0.79	-2.5	4.79	4.58	
Netherlands	+49.0 Jul	+53.5 Q2	+7.9	0.71	0.79	-0.6	4.79	4.41	
Spain	-123.8 Jul	-122.3 Jun	-9.0	0.71	0.79	1.7	4.79	4.43	
Czech Republic	+3.1 Jul	-4.5 Jul	-3.5	19.5	22.3	-4.1	3.49	4.49	
Denmark	+4.8 Jul	+4.7 Jul	+1.5	5.27	5.88	3.8	4.90	4.44	
Hungary	-1.9 Jul	-6.8 Q2	-5.2	178	217	-6.0	7.44	6.58	
Norway	+53.3 Aug	+54.6 Q2	+14.2	5.43	6.62	18.9	5.59	4.90	
Poland	-9.2 Aug	-12.6 Jul	-3.3	2.67	3.10	-2.2	5.09	5.71	
Russia	+121.4 Aug	+73.3 Q3	+6.8	25.0	26.8	3.0	10.00	6.34	
Sweden	+18.1 Aug	+29.7 Q2	+6.9	6.50	7.35	2.4	3.60	4.32	
Switzerland	+11.1 Aug	+102.1 Q2	+16.4	1.18	1.25	0.3	2.80	2.91	
Turkey	-56.4 Aug	-33.2 Jul	-7.3	1.20	1.51	-2.8	6.68	6.91§	
Australia	-13.0 Aug	-47.1 Q2	-5.7	1.13	1.35	1.3	6.86	6.14	
Hong Kong	-20.6 Aug	+25.3 Q2	+10.9	7.76	7.79	1.8	5.19	4.16	
India	-70.7 Aug	-9.7 Q2	-1.4	39.6	45.7	-3.3	7.17	8.29	
Indonesia	+41.7 Aug	+11.1 Q2	+2.3	9124	9220	-1.7	8.15	6.52§	
Malaysia	+28.7 Aug	+25.9 Q1	+13.8	3.41	3.69	-3.2	3.62	5.06§	
Pakistan	-13.6 Aug	-6.8 Q1	-4.5	60.7	60.6	-4.6	9.75	8.54§	
Singapore	+38.1 Aug	+41.6 Q2	+25.7	1.48	1.58	0.3	2.44	2.71	
South Korea	+20.1 Sep	+6.9 Jul	+0.4	914	949	0.5	5.34	5.53	
Taiwan	+14.3 Aug	+28.3 Q2	+6.3	32.6	33.1	-2.0	2.60	2.71	
Thailand	+10.2 Aug	+11.5 Jul	+3.5	34.2	37.6	-1.9	3.55	4.33	
Argentina	+10.2 Aug	+7.4 Q2	+3.5	3.15	3.10	1.5	12.94	na	
Brazil	+43.1 Sep	+10.6 Aug	+0.7	1.82	2.17	-1.8	11.18	6.16§	
Chile	+24.4 Aug	+8.3 Q2	+3.3	505	535	8.0	5.88	5.10§	
Colombia	-1.5 Jun	-4.1 Q1	-3.0	2013	2405	-0.2	8.77	6.10§	
Mexico	-1.2 Aug	-7.0 Q2	-1.0	10.9	11.1	0.1	7.19	7.85	
Venezuela	+23.8 Q2	+20.4 Q2	+8.1	2147	2807	-2.6	11.00	6.55§	
Egypt	-14.1 Q1	+3.1 Q1	+2.3	5.58	5.74	-5.5	7.21	5.41§	
Israel	-9.0 Aug	+7.8 Q2	+3.4	4.01	4.27	-0.9	4.25	5.18	
Saudi Arabia	+146.6 2006	+98.9 2006	+23.3	3.74	3.75	18.7	5.08	na	
South Africa	-9.6 Aug	-17.4 Q2	-6.3	6.89	7.95	0.5	10.40	8.23	

* Merchandise trade only.

† The Economist poll.

‡ Economist Intelligence Unit forecast.

§ Dollar denominated bonds.

EXHIBITS 11 & 12: Index Tables (period ending September 30, 2007)

INTERNATIONAL DEVELOPED MARKET PERFORMANCE

REGIONS	In Local Currency		In US Dollars	
	Q307	YTD	Q307	YTD
EAFE	-2.47%	7.09%	2.23%	13.57%
EURO	-2.00%	10.57%	3.19%	19.25%
EUROPE	-2.28%	8.08%	1.72%	14.88%
THE WORLD INDEX	-0.10%	8.38%	2.46%	12.17%
PACIFIC	-2.73%	5.18%	3.40%	10.68%
WORLD ex USA	-2.11%	7.40%	2.77%	14.72%

NATIONAL INDICES

AUSTRALIA	6.92%	20.34%	11.52%	35.11%
AUSTRIA	-12.96%	-5.31%	-8.35%	2.13%
BELGIUM	-9.37%	-3.26%	-4.57%	4.34%
CANADA	2.42%	11.25%	9.64%	30.28%
DENMARK	3.69%	16.74%	9.01%	25.91%
FINLAND	13.04%	42.15%	19.03%	53.31%
FRANCE	-5.43%	4.92%	-0.41%	13.16%
GERMANY	-1.53%	19.93%	3.69%	29.35%
GREECE	5.48%	15.92%	11.07%	25.02%
HONG KONG	23.16%	31.65%	23.94%	31.80%
IRELAND	-16.61%	-16.19%	-12.19%	-9.61%
ITALY	-4.72%	-1.28%	0.33%	6.47%
JAPAN	-7.63%	-1.49%	-0.82%	2.05%
NETHERLANDS	0.13%	14.31%	5.44%	23.28%
NEW ZEALAND	1.58%	6.21%	-0.65%	13.82%
NORWAY	-1.23%	15.95%	7.59%	33.14%
PORTUGAL	-10.89%	7.63%	-6.16%	16.08%
SINGAPORE	5.75%	28.54%	8.96%	32.86%
SINGAPORE FREE	5.75%	28.54%	8.96%	32.86%
SPAIN	-0.07%	6.65%	5.22%	15.02%
SWEDEN	-3.41%	9.95%	2.39%	16.31%
SWITZERLAND	-3.17%	3.49%	1.59%	8.15%
UNITED KINGDOM	-1.35%	6.66%	0.17%	11.03%

Source: Morgan Stanley Capital International

INTERNATIONAL EMERGING MARKET PERFORMANCE

REGIONS	In Local Currency		In US Dollars	
	Q307	YTD	Q307	YTD
EM (EMERGING MARKETS)	11.81%	27.07%	13.70%	32.02%
EM ASIA	16.83%	35.37%	17.85%	38.20%
EM EASTERN EUROPE	5.00%	5.87%	7.07%	9.11%
EM EUROPE	6.08%	8.77%	8.89%	13.69%
EM EUROPE & MIDDLE EAST	5.51%	10.65%	8.64%	15.55%
EM LATIN AMERICA	7.65%	27.21%	10.27%	38.19%

NATIONAL INDICES

ARGENTINA	4.99%	9.35%	2.99%	6.49%
BRAZIL	14.70%	34.06%	20.06%	55.55%
CHINA	40.20%	69.30%	41.09%	69.48%
CHILE	-5.55%	18.46%	-2.68%	23.32%
COLOMBIA	2.30%	-1.72%	-1.01%	8.78%
CZECH REPUBLIC	1.82%	22.24%	12.09%	32.02%
EGYPT	9.34%	22.27%	11.34%	24.92%
HUNGARY	-3.72%	11.98%	-0.84%	20.84%
INDIA	17.26%	25.17%	19.85%	39.03%
INDONESIA	15.96%	30.56%	14.57%	28.39%
ISRAEL	2.55%	23.74%	7.75%	29.09%
JORDAN	-4.00%	-2.69%	-3.98%	-2.62%
KOREA	12.83%	34.07%	13.91%	36.25%
MALAYSIA	-1.31%	22.65%	-0.01%	26.98%
MEXICO	-3.43%	14.06%	-4.69%	12.93%
MOROCCO	8.76%	32.77%	13.41%	41.20%
PAKISTAN	-6.47%	29.64%	-6.84%	30.01%
PERU	20.18%	94.49%	21.17%	96.62%
PHILIPPINES	-3.81%	18.18%	-1.24%	28.57%
POLAND	-4.39%	10.09%	0.47%	20.63%
RUSSIA	8.16%	3.63%	8.96%	4.79%
SOUTH AFRICA	2.72%	11.40%	5.03%	13.88%
SRI LANKA	-7.44%	-13.68%	-9.12%	-18.24%
TAIWAN	3.34%	14.34%	4.07%	14.17%
THAILAND	11.22%	26.59%	12.03%	33.51%
TURKEY	15.39%	37.45%	24.41%	60.73%
VENEZUELA	-9.54%	-40.40%	-9.54%	-7.20%

Source: Morgan Stanley Capital International

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